

Message Text

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INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03
INR-10 NSAE-00 ICA-11 TRSE-00 XMB-02 OPIC-03
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P 122259Z SEP 78
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC PRIORITY 8619
INFO AMEMBASSY PARIS
AMCONSUL MONTREAL
OTHER CANADIAN POSTS POUCH

C O N F I D E N T I A L SECTION 01 OF 02 OTTAWA 04447

E.O. 11652: GDS
TAGS: EFIN, CA
SUBJECT: BANK RATE INCREASED; MONEY TARGET LOWERED

USOECD

1. SUMMARY. WITH CANADIAN DOLLAR UNDER HEAVY SELLING PRESSURE, BANK OF CANADA INCREASED BANK RATE TO 9.5 PERCENT EVENING OF SEPTEMBER 11. BANK ALSO ANNOUNCED LOWERING OF MONEY SUPPLY (M-1) GROWTH TARGET RANGE TO BETWEEN SIX AND TEN PERCENT FROM A NEW BASE OF JUNE, 1978. RATE INCREASE WAS DESIGNED TO SUPPORT FALTERING EXCHANGE RATE BY INCREASING SPREADS WITH SIMILAR U.S. SHORT TERM RATES, BUT WAS DONE RELUCTANTLY BECAUSE OF HIGHER DEBT MANAGEMENT COSTS TO GOC. END SUMMARY.

2. BANK RATE INCREASE TO 9.5 PERCENT ANNOUNCED AFTER CLOSE OF MARKETS SEPTEMBER 11 WAS FOURTH ONE HALF OF ONE PERCENTAGE POINT INCREASE THIS YEAR (OTHERS WERE IN MARCH, APRIL, AND JULY), ALL OF WHICH WERE DESIGNED PRIMARILY TO DEFEND CANADIAN DOLLAR EXCHANGE RATE BY
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MAINTAINING SHORT TERM INTEREST RATE SPREADS WITH
RISING U.S. RATES.

3. INDICATIONS ARE THAT LATEST INCREASE WAS TAKEN RELUCTANTLY AND UNDER PRESSURE BECAUSE OF BATTERING SUFFERED BY CANADIAN DOLLAR FOLLOWING PUBLICATION FRIDAY SEPT. 8 OF BAD SECOND QUARTER BALANCE OF PAYMENTS

FIGURES (A CURRENT ACCOUNT DEFICIT OF CDOLS 1.4 BILLION)
--SEE SEPTTEL--WHICH FOLLOWED CLOSE ON HEELS OF TRADE
DEFICIT REPORT FOR JULY.

4. BANK OF CANADA OFFICIALS TOLD EMBOFF LAST WEEK THAT SENTIMENT THEN IN BANK WAS STILL RUNNING AGAINST BANK RATE INCREASE BECAUSE EARLIER INCREASES HAD ONLY LIMITED AND TRANSIENT EFFECT ON EXCHANGE MARKETS AND EXPECTATION OF HIGHER DOMESTIC RATES WOULD INCREASE COSTS OF DEBT MANAGEMENT. (CANADA SAVINGS BOND CAMPAIGN, WHICH INVOLVES REFINANCING ABOUT CDOLS 2 BILLION OF MATURING BONDS, IS DUE TO START OCTOBER 2.) BANK OF CANADA HAD BEEN SELLING TREASURY BILLS IN ORDER TO HOLD DOWN SHORT RATES AND INTERVENING IN EXCHANGE MARKETS TO HOLD UP EXCHANGE RATE, BUT FOREX MARKET PRESSURES AND INTERVENTION COSTS APPARENTLY BECAME TOO GREAT. DESPITE REPORTED HEAVY INTERVENTION, CANADIAN DOLLAR RATE SLIPPED BADLY ON MONDAY SEPTEMBER 11, CLOSING BELOW 86 U.S. CENTS. FOLLOWING BANK RATE INCREASE MONDAY NIGHT, RATE RECOVERED SLIGHTLY ON TUESDAY, SEPTEMBER 12, CLOSING AT 86.01 U.S. CENTS.

5. NEW MONEY SUPPLY TARGET. BANKS RATE INCREASE WAS ACCOMPANIED BY ANNOUNCEMENT OF LOWER MONEY SUPPLY TARGET. NEW TARGET WILL BE ANNUAL RATE OF INCREASE OF M-1 OF SIX TO TEN PERCENT FROM A BASE OF JUNE, 1978.
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OLD TARGET HAD BEEN RANGE OF SEVEN TO ELEVEN PERCENT FROM BASE OF JUNE, 1977. LOWER TARGET RANGE, WHICH HAD BEEN WIDELY EXPECTED, IS DESIGNED TO REASSURE MARKETS OF ANTI-INFLATIONARY MONETARY POLICY STANCE OF GRADUALLY REDUCED TARGETS FOR MONEY SUPPLY INCREASES.

6. ARITHMETIC OF NEW BASE FOR CALCULATING M-1 GROWTH RATE HAS THE EFFECT OF CHANGING MEASURED ANNUAL RATES OF GROWTH FOR THE MONEY SUPPLY. ANNUAL RATES OF INCREASE FOR M-1 FROM JUNE 1977 BASE WERE 8.8 AND 9.5 PERCENT IN JULY AND AUGUST, RESPECTIVELY, ROUGHLY IN THE MIDDLE OF THE OLD TARGET RANGE. HOWEVER, THE SAME SEASONALLY ADJUSTED M-1 FIGURES FOR JULY AND AUGUST SHOW AN ANNUAL RATE OF INCREASE FOR THIS SHORT PERIOD OF 11.8 AND 14.1 PERCENT ABOVE THE NEW JUNE 1978 BASE-- FAR ABOVE THE NEW TARGET RANGE. HIGHER INTEREST RATES IN CANADA WILL OF COURSE TEND TO BRING DOWN RATES OF INCREASE IN M-1.

7. COMMENT. DESPITE THE LATEST BANK RATE INCREASE, THE SHORT TERM OUTLOOK FOR THE CANADIAN DOLLAR IS NOT GOOD. WIDENING OF INTEREST RATE SPREADS WITH THE U.S.

MAY HELP STEM SHORT TERM CAPITAL OUTFLOWS OR ENCOURAGE
SOME INFLOWS, BUT GIVEN THE CURRENT BEARISH MARKET
SENTIMENT ON THE DOLLAR, LITTLE IMPROVEMENT CAN BE
EXPECTED UNLESS THERE IS DEMONSTRABLE IMPROVEMENT IN
FUNDAMENTAL CANADIAN ECONOMIC PERFORMANCE. WHILE THERE
SHOULD BE SOME MODEST IMPROVEMENT IN THE TRADE BALANCE
AND INFLATION IN THE THIRD QUARTER OVER THE SECOND,
LITTLE IMPROVEMENT IN UNDERLYING TRENDS CAN BE EXPECTED
SOON. THERE HAS ALSO BEEN LITTLE AUTONOMOUS FOREIGN
BORROWING IN RECENT MONTHS TO HELP PROP UP THE EXCHANGE
RATE. IT IS THUS INCREASINGLY LIKELY THERE WILL BE

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C O N F I D E N T I A L SECTION 02 OF 02 OTTAWA 04447

ANOTHER GOC FOREIGN BOND ISSUE ANNOUNCED IN COMING
MONTHS.
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